DOCUMENT RESUME

ED 077 370 HE 004 167

TITLE	Pay-As-You-Earn: Summary Report and Recommendations. Ford Foundation Studies in Income Contingent Loans for Higher Education.
INSTITUTION	Ford Foundation, New York, N.Y.
PUB DATE	Sep 72
NOTE	18p.
AVAILABLE FROM	Ford Foundation, Office of Reports, 320 East 43rd Street, New York, N. Y. 10017
EDRS PRICE	MF-$0.65 HC-$3.29
DESCRIPTORS	*Educational Economics; *Educational Finance; Federal Programs; *Financial Needs; Financial Support; *Higher Education; Research; Research Projects; *Student Loan Programs

ABSTRACT

The summary report and recommendations of the Ford Foundation studies in income contingent loans for higher education are presented. Recommendations regarding the pay-as-you-earn concept concern the role of credit in financing higher education; the search for more manageable debt; capitalizing a loan plan; institutional loan plans; short-term recommendations; and a national policy for student loans; long-term recommendations. A 26-item bibliography is included. (MJM)

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Ford Foundation Studies in Income Contingent Loans for Higher Education

Summary Report and Recommendations

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Library of Congress Card Number 72-90790 September 1972

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Background of the Studies

Mounting concern over the rising costs and financial troubles of our colleges and universities has led to an increasing interest in the role of loans in financing higher education. Recently, much of this attention has been focused on a relatively new concept in lending, variously referred to as tuition postponement, deferred tuition, income contingent lending, or the pay-as-you-earn concept.

Unlike a conventional loan, which obligates the borrower to a fixed schedule of payments, an income contingent loan obligates the borrower to some percent of future annual income, with upper limits on the repayment period and the total repayment liability. Proponents have claimed that such an instrument would provide more manageable credit by distributing payments over time in accord with ability-to-pay and by "mutualizing" some of the risk of future low income. Critics and skeptics have questioned the financial, legal, and administrative feasibility of such plans, as well as their possible impact on public, parental, and alumni support of higher education.

In early 1971, Yale University announced the first operational program of income contingent lending, to begin in the fall of 1971. Duke University soon followed with a similar, more limited plan; and many colleges, universities, professional schools, and state executive and legislative agencies expressed their interest in this new loan concept.

Stimulated by Yale's Tuition Postponement Option, the Ford Foundation began a series of studies on the "pay-as-you-earn" concept. The PAYE project focused on the following sets of questions:

1. What is the range of instruments which may properly be called "income contingent"? How do the alternative plans vary with the expected incomes of the borrowers and the rates of return sought by the lender? How can plans be constructed featuring different annual repayment rates and repayment periods, affording different degrees of protection to low earners, and carrying different liabilities to high earning borrowers?

2. How might some of the goals sought through income contingency—e.g., a correlation of payments to future income and a protection against unmanageable debt due to low future earnings—be achieved with more conventional debt instruments and through existing governmental and institutional loan plans?

3. What are the legal, financial, and administrative problems attached to income contingent and other loan plans, and how might these be surmounted?

4. What are student attitudes toward loans, including various income contingent options?

5. Do income contingent loans or "hybrid" income contingent-fixed schedule instruments have an ultimate role in the financing of higher education? What would such loan plans look like? And what would be the roles of government, the private capital market, and the higher educational institutions in this lending?

6. Do income contingent loans—or "hybrid" variants—have widespread immediate application without major changes in public policy, or new federal or state legislation? What plan or plans can be implemented now by institutions seeking more effective use of credit in a form which will be manageable to the student borrower?

Findings with respect to these and other questions are included in a Ford Foundation report to be published early in 1973 by the Columbia University Press entitled *New Patterns for College Lending: Income Contingent Loans* by D. Bruce Johnstone with the assistance of Stephen P. Dresch. What follows is a summary of the major findings and recommendations of that report.

The Role of Credit in Financing Higher Education

1 Conventional student loans already play an important role in the financing of higher education. As the student- and family-borne costs of college continue to increase, so will the reliance on credit.

There is no end in sight to the rapid increase in the costs of college borne by the student and his family. While parental contributions, summer and term-time employment, and need-based student aid will continue to absorb some of these increased costs, there can be little doubt that loans of some kind will play an ever increasing role. Student borrowing more than doubled between 1968 and 1971, and it is estimated that at least 1.5 million students will borrow more than $1.5 billion during the 1971-72 academic year to cover some portion of their college costs. Although borrowing occurs most heavily among those from lower income families, graduate students, and students at private colleges, it is not unreasonable to project that at least half of the students currently enrolled in higher education will leave school with an educational debt.

2 Loans of any sort are merely devices for financing some portion of those costs of higher education reflected in tuition, fees, and living costs. Neither income contingent nor any other kind of loan instrument should determine the proportion of the total costs of education which are to be borne by the student/family unit.

The "proper" level of tuition can only be resolved through advancing our understanding of: (a) the public and private benefits of higher education; (b) the enrollment behavior of students in response to different levels of tuition; and (c) the effects of different pricing policies on the quality of education, the efficiency of resource use, and the equality of opportunity. The necessary amount and form of credit can only *follow from* a resolution of those fundamental issues. The case for or against a particular form of credit instrument—e.g., an income contingent loan—should not be allowed to obscure, or be obscured by, alternative philosophies of financial support for higher education.

The Search for More Manageable Debt

3 Debt can be made more manageable through: (a) extending repayment periods for larger debts; (b) distributing a given repayment obligation over time in accord with the borrower's changing income; and (c) providing

some protection in the form of debt forgiveness in the event of low future earnings.

Repayment periods on nearly all forms of educational credit are currently limited to no more than 10 years. These terms are probably sufficient for most borrowers today, but they may already be inadequate for some graduate and professional students with larger accumulated debts, and they will almost certainly be inadequate for many future borrowers.

Conventional student loans are repaid in fixed, equal, or occasionally even declining, installments. This places a relatively greater burden on the early repayment years when incomes are generally lowest and financial obligations of starting a family or business often high. Regardless of the length of the repayment period, a relatively constant relationship between payments and income would seem generally more manageable than one which concentrated the burden at the beginning of the earning career.

Even distributed over time in accord with an individual's changing income, a given repayment obligation may become excessive (or excessively long) in the event that income is low. Some ultimate forgiveness of part of this burden in the event of low future earnings can be rationalized on two grounds. First, such a provision might make students more willing to invest in their own education; "low income protection" could reduce the risk of investment in human capital in much the same way that "equity" and "limited liability" reduce the risk of investment in venturesome commercial enterprises. Second, some protection against the failure of higher education to "pay off" might also be justified on the basis of equity. As long as higher education remains the *sine qua non* for social and economic mobility, the individual's investment of time, money, and foregone earnings is not strictly voluntary. However, at the same time that costs of education are increasing, the monetary returns—at least for less than a four-year baccalaureate—may actually be becoming less certain. If the student is to continue bearing a major portion of the costs of college, he or she should at least be accorded some means of hedging against the possibility of declining returns to that investment.

4 **"More manageable debt instruments" include: (a) income contingent loans, (b) fixed schedule (conventional) loans with payments graduated over time in accord with the expected growth in average earnings, and (c) "hybrid" income contingent-graduated payment loans, in which the borrower is obligated to a fixed scheduled payment (graduated over time) or a percent of income, whichever is less.**

Income contingent loans obligate the borrower to payment of some percent of annual income (generally per $1000 borrowed) for a maximum repayment period or until the borrower has reached some upper limit on either annual or accumulated payments. Some low earning borrowers will reach the end of the repayment period having repaid less than the cost of their loans. If the loan plan must "break even"—i.e., recover costs of money, loan servicing, etc. from all bor-

rowers as a group—the upper limit on liability must be set high enough to generate "surpluses" from the high earners just sufficient to recover the "losses" on the low earners. The risk of low future income in such plans is thus mutualized among the borrowers. Lower repayment rates and/or shorter maximum repayment periods anticipate more borrowers repaying less than the full costs of their loans and provide more low earnings protection. The greater the expected losses on low earners, the higher must be the upper limits on the repayment liabilities of the high earners. For any set of expected future incomes of borrowers, there is an unlimited number of loan plans—differing in repayment rates, maximum repayment periods, and upper limits on liability—which will just break even at any desired rate of return to the lender.

Graduated payment loans are simply conventional, fixed-schedule loans with payments increasing over time in accord with the expected growth in future earnings of the average borrower. A borrower's actual future earnings would have no bearing upon payments, although the repayment obligation of most borrowers should be distributed over time in *approximate* accord with the growth in their earnings. Repayment obligations would be the same for all borrowers, and no protection would be accorded the low earner.

Graduated payment loans with percent-of-income repayment ceilings are "hybrid" models. Borrowers would owe according to a fixed, graduated schedule, but would be entitled to a deferment of any amount owed in excess of some stipulated percent-of-income thought to constitute a "maximum reasonable burden" for debt payment. Most borrowers would make the scheduled payment in every year and simply be accorded the convenience of a graduated payment schedule. Some of the low earning borrowers in any given year would be entitled to pay only the stipulated maximum percent of their incomes and defer the remainder until the following year. Those experiencing only a temporary year or two of low income would quickly make up their deferred payments and return to the original graduated payment schedule, having simply been granted a temporary second line of credit to accommodate their schedule of payments to their schedule of earnings. Those whose incomes remain low, however, would continue to pay on the income contingent basis, deferring ever larger amounts and arriving at the end of the repayment period with an outstanding debt. That amount would be forgiven, just as would any amount still "owed" by a borrower in a fully income contingent loan plan at the end of the repayment period.

Like a fully income contingent plan, a "hybrid model" could be constructed with any desired degree of low income protection by varying the repayment ceiling; the lower the ceiling, the more the protection. If the forgiven payments to low earners are to be recovered from higher earning participants, the fixed, graduated schedule would have to be set to recover some rate of return in excess of cost sufficient to compensate for the forgiven debts of the low earners.*

* Such a plan might also be described as an income contingent plan which limits the liability of high earners to a fixed schedule of *annual* upper payments, but obligates all borrowers for the entire repayment period, as contrasted with a fully income contingent plan which limits *accumulated* liability, but allows those reaching the limit to "exit" before the maximum repayment period.

5 The "hybrid" model offers most of the convenience and protection of a fully income contingent loan with the simplicity and certainty of fixed-schedule payments for most borrowers.

An income continent obligation maintains a constant burden of payments relative to income for all borrowers. The "hybrid" model, by contrast, maintains payments at a constant percent of income only for the low earners, who repay on the income contingent repayment ceiling, and for other borrowers whose incomes grow at the "expected average rate" used to generate the fixed, graduated repayment schedule. Borrowers whose incomes either fluctuate annually or grow faster or more slowly than the graduated payment schedule might find their repayment obligations bearing, at best, only an approximate relationship to their yearly incomes.

The "hybrid" model, then, does not distribute payments over time precisely in accord with income for all borrowers. It does, however, guarantee that the repayment burden will not exceed some stipulated maximum percent of income. Furthermore, a graduated, fixed schedule is considerably simpler and probably cheaper to administer than a fully income contingent obligation. Each borrower could be billed for the exact amount due. Individual incomes, for the great majority of borrowers, would play no role, and would not have to be reported by the borrower nor monitored by the lender. (In this regard, payments would be considered fixed even if interest rates were to "float" with the prime rate or with some other index of money cost.) This advantage might be erased with income contingent payments collected along with income taxes by the Internal Revenue Service. Short of such an arrangement, however, fixed schedule payments should provide substantially lower administrative costs and probably fewer defaults than income-based payments.

6 The cost of the low earnings protection—i.e., the shortfalls on payments of low earners—may be recovered either through: (a) surplus payments made by higher earning borrowers, or (b) some external source of subsidy such as the government or the university.

Mutualized plans, designed to break even over a group of borrowers, must recover surplus payments from high earners just sufficient to make up for the shortfalls on the payments of low earners. In an income contingent plan, the high earner pays a percent of annual income until accumulated payments have reached some *upper limit on liability*. The higher this upper limit, other things being equal, the more "surplus" will be generated and the more "low earnings protection" can be built into the plan. The upper limit might be set as a premium (e.g., 10%) rate of interest, or as a multiple (e.g., 150%) of the original principal borrowed plus the cost of money and loan servicing. In a mutualized "hybrid" model, the fixed, graduated payment schedule would be set to return some surplus to the lender and make up for the losses on the low earners who would repay only on the percent-of-income repayment ceiling.

Mutualized plans may be compared to *insurance* or to *equity finance*. Under

the insurance analogy, all borrowers can be thought of as paying a premium in return for the assurance that they will be forgiven some portion of their debt in the event of low earnings. Low earners who terminate their obligations having repaid less than cost "collect" on their insurance; others pay the full premium, but receive protection and security throughout their borrowing and repayment years. Under the equity finance analogy, the investor (the lender) balances the risk of loss (the probability of the borrower being a low earner) with the risk of gain (the probability of the borrower being a high earner). By either analogy, the risk of low earnings is mutualized among the group of borrowers.

Losses on low earners, however, could also be recovered from an external source of subsidy, preferably the state or federal government. Most borrowers under such a plan would repay only the cost of their own loans. Some portion of low earning borrowers would terminate payments having repaid their loans at rates of interest below cost. These borrowers would be subsidized on the basis of their low actual earnings, just as students are currently subsidized on such criteria as low parental income, scholarship, special talent, or attendance at a low tuition public institution. Since no borrower would repay more than cost and some would repay less, the loan plan as a whole would recover less than cost and would depend on governmental or institutional subsidization.

It is impossible to identify precisely the *un*subsidized cost of unsecured student loans. Virtually all student loans, in fact, are directly or indirectly subsidized, if only by state or federal guarantees to the lender. For this reason, we cannot perfectly distinguish between "mutualized" and "externally subsidized" loan plans, nor can we unambiguously identify every borrower, upon completion of his or her obligation, as having repaid at, above, or below "cost." For convenience, however, we will assume "cost" to be the 7% rate of interest paid by borrowers in the repayment stage under the federal Guaranteed Student Loan Program. We will define a "mutualized" plan, then, as one which is designed to recover about 7% from the borrowers as a group, but in which individual borrowers, by virtue of earnings, may repay appreciably more or less. An externally subsidized plan would be one which receives no more than 7% from the highest earners, but less than 7% from some low earners and thus from all borrowers as a group. (It would be quite possible, of course, to combine both models: to recover less than 7% from a group of borrowers, yet more than 7% from the highest earners. Such a plan would share the cost of "subsidizing" low earners between high earners and an external source of subsidy.)

7 **"Mutualization" raises a number of potentially troublesome issues such as adverse selection and risk rating. These issues are avoided if borrowers are held responsible only for their own loans and low earners protected through an external source of subsidy. While little is known of the relative benefits of alternative forms of subsidy, we consider low earnings protection to be a legitimate and beneficial use of public funds.**

Any plan which must recover expected losses on low earners through surplus

payments from high earners runs a risk of "adverse selection," or the disproportionately low participation of probable high earners due to their fear of having to repay at a cost considerably greater than that of alternative conventional loan plans. We do not yet know the degree to which potential borrowers will sort themselves into participants or nonparticipants in a mutualized plan due to income expectations. Nor do we know how accurate these expectations are and what actual effect any sorting might have on the financial viability of a loan plan. The threat of adverse selection, however, definitely constrains the range of student types or institutions over which risk can be mutualized. It also limits the possibilities of offering alternative loan options which might feature varying amounts of protection to low earners and thus varying limits on the liabilities of high earners. Limiting the liability of borrowers to no more than the prevailing rate on conventional student loans would encourage participation of students in any plan regardless of income expectations.

In addition, mutualization of risk will very likely lead to risk rating of students in order to remove *predictable* differentials in future earning capacity at the time of borrowing. Risk rating of borrowers on the basis of income prospects would necessarily discriminate on such bases as aptitude, socio-economic status, race, sex, and probable career choice. Risk rating borrowers, however, seems both politically and ethically indefensible. Yet, if students cannot be risk rated, the insurance and equity finance analogies are weakened, and the protection of low earners begins to resemble simply the subsidization of low by high earning borrowers. We may at this point question why the responsibility of assisting low earners should fall only on those high earners who were sufficiently needy perhaps 20 years ago to have had to borrow. Should not this responsibility be borne by all high earners through the income tax and governmental subsidization? The subsidy received by a low earning borrower who repays less than the cost of his loan might be considered a deferred student grant—awarded on the basis of the failure of his educational investment to bring a minimal monetary return.

There can be little question that students would prefer subsidized to unsubsidized loans, or that they would be more willing to participate, all else being equal, when the upper limit on liability is 7% rather than 11-12%. The case for external subsidization of the low earner, however, must be based on the claim that that particular form of subsidy is an efficient and equitable use of public funds. Does a dollar committed to future debt forgiveness for low earners promote more access to higher education than a dollar spent on direct student aid or lower tuitions for all? The answer depends on how much future low earnings protection can be secured for a dollar's worth of aid based, say, on current family income, and on how those alternative forms of subsidy translate into student willingness to invest in higher education. We are not able to say at this time what these trade-offs are. We do believe, however, that students want and deserve protection against the risk of unmanageable debt. We also feel that repayment forgiveness in the event of low earnings would be a considerably more efficient and equitable use of public funds than many of the current public subsidies

which are unrelated to any measure of need. Given the potential difficulties with mutualization, we strongly recommend further exploration of the alternative of external subsidization of the low earner.

Capitalizing a Loan Plan

8 The capital risk of long-term student loans of any kind, whether income contingent or fixed schedule, must be borne either by the government or by higher educational institutions themselves.

The private capital market is not at present willing to bear the capital risk of any form of unsecured, long-term loans to students except at extremely high rates of interest.* This reluctance is principally due to the risk of defaults. Income contingent loans, however, carry a risk to the lender not simply of the failure of borrowers to live up to their contractual obligations, but of the failure of their incomes (and hence their payments) to increase as anticipated. At present, then, there seems to be little chance for private capitalization of an income contingent loan plan without full guarantees either by the government or by the lending college, through a pledge of unrestricted endowment assets (i.e., endowment or "funds functioning as endowment" upon which there are no legal obligations with respect to either income or corpus). Because existing state and federal student loan guarantee programs do not cover income contingent loans, such lending must at present be limited to those colleges and universities willing and able to either liquidate or collateralize unrestricted endowment assets.**

9 Only government is capable in the long run of bearing the capital risk on student loans having any income contingent provisions.

Few institutions have sufficient unrestricted liquid assets to capitalize any large scale loan program for any length of time. The only way income contingent or "hybrid" income contingent-fixed schedule plans can become generally available is either through direct governmental capitalization, as in the National Defense Student Loan Plan, or through state and/or federal assumption of the capital risk, as in the state and federal guaranteed loan plans. This entails assumption of the risk of repayment shortfalls due to lower-than-anticipated incomes of all borrowers as well as the more conventional risk of default. The assumption of

* Some notion of what such interest rates might be can be inferred from the interest rates currently charged on nonguaranteed, *short-term* (e.g., five years) educational loans to *credit worthy parents*. Such loans were available from commercial banks in New York City in the spring of 1972 at 12 per cent. Privately capitalized loan plans available to parents through colleges charge up to 18 per cent.

** The accumulation of income contingent (or any other kind of) student loan notes without drawing on assets or incurring a corresponding liability is possible, of course, providing the college is willing and able to operate on a continuing budget surplus.

risk would be simplified were the government to assume responsibility for repayment forgiveness in the event of low future incomes, as suggested in #7, above.

Institutional Loan Plans: A Short-Term Recommendation

10 Institutions seeking immediately to expand the use of loans in their total student aid package should consider a fixed schedule-graduated payment loan which meets all specifications of the federal Guaranteed Student Loan Plan. To this essentially conventional loan note, the institution might attach a second contract guaranteeing a deferment and an eventual forgiveness of all payments in excess of some stipulated percent of income. The short-term recommendation, then, is for a "hybrid" graduated payment-income contingent loan as described above, which would fit within the federal Guaranteed Student Loan Program.

Any college or university is eligible to participate as a lender in the Guaranteed Student Loan Plan. Benefits of participation include: (1) state and/or federal assumption of all or most of the capital risks; (2) federal interest supplements (currently 1.25%) paid to the lender during times of high interest rates; (3) federal assumption of all interest payments during the deferment period (full-time enrollment in higher education and up to three years of military, Peace Corps, or VISTA Service) for all borrowers with demonstrated need; and (4) eligibility of notes for sale or warehousing to the Student Loan Marketing Association, the new federally sponsored secondary market for student loan paper.

The basic requirements for loan instruments which may be entitled to state and federal guarantees are:

a) no more than 7% annual interest charged to the borrower;
b) no less than $360 to be repaid in any single repayment year;
c) a repayment period not to exceed 10 years after the initiation of payments;
d) a repayment period not less than five years, except in the case of voluntary acceleration of repayment or cases in which the minimum annual payment would amortize the loan in less than five years.

Except for small debts constrained by the five-year minimum term and the $360 minimum annual payment, guaranteed student loans may be repaid on a schedule graduated over time at the expected annual rate of growth of borrowers' incomes. The basic note, then, would be a graduated payment loan carrying all the benefits, to both lender and borrower, outlined above.

To that basic note could be attached a second contract by which the lender

(the college) would pledge to defer any amount of payment due in excess of X% of the borrower's annual income. The repayment ceiling would be a guaranteed second line of credit to protect the borrower from unmanageable payments in the event of low earnings. Any amount deferred would be added to the next year's payments due. If the low income were an "aberrant" year of low earnings, the borrower would quickly repay his second note and return to the original repayment schedule. If the low income were permanent, however, the borrower would continue to defer increasing amounts, always paying the maximum percent of income rather than the fixed amount due. At the end of the repayment period—plus some extension, if the lender wished to cut further losses—the borrower would be forgiven any remaining debt.

Given the statutory limitation of 7% on interest charged to the student, the forgiven balances of the low earners would have to be absorbed by the college. Such a plan would, in effect, entail a decision by the college that the present value of these future losses from low earners was a better use of potential college resources than alternatives such as more current need-based aid, lower tuitions, higher faculty salaries, or other instructional expenditures. Variations in the repayment ceiling and extensions of the repayment period could allow the lender considerable control over the probable losses on low earners. However, the returns to such a plan, even with the repayment ceiling, could still exceed that earned on many current, college-originated loan plans.

The source of capital funds could be the new federally sponsored secondary market, bank borrowing, the institution's own revolving loan funds, or its endowment. With no risk attached to the basic federally guaranteed note, capitalization should not be a major problem. Collection and servicing could either remain in the hands of the college or be contracted to a bank or agency specializing in the servicing of college loans.

A National Policy for Student Loans: Long-Term Recommendations

11 **A wide variety of loan options should be made available to students. State and federal guarantee agencies must continue to bear the capital risk. Repayment periods should be extended, at least for larger debts; graduated payment schedules encouraged; and colleges and universities encouraged to lend under the guarantee programs. A federal secondary market should be created to capitalize all approved college- and university-originated lending, and to provide necessary liquidity to the private financial sector. Finally, federal and state governments should explore the costs and benefits of assuming the**

responsibility of forgiving repayments in the event of low future earnings. Such a "deferred grant" program should complement expanded state and federal programs of portable grants based on need and current family income.

Our most potentially far-reaching recommendation is for governmental assumption of the responsibility for forgiving some portion of payments in the event of low future earnings. Such a policy would have to be based on further research—e.g., the enrollment-inducing effect of a low earnings protection clause compared to alternative forms of subsidy such as institutional aid or direct student grants. At this time, we feel that a forgiveness of repayment in the event of low future earnings will prove to be a wise expenditure of public funds and a more viable means of perfecting the market for human capital than mutualization of risk among borrowers.

We are not recommending a specific new national loan plan at this time—income contingent or otherwise. In part, this is because we feel there should be a number of plans and instruments available for different students, different institutions, and different levels of borrowing. We have too much to learn about income contingent instruments, student borrowing preferences, floating interest rates, secondary markets, and the like to advance any single plan of educational credit at this time. We also feel that a national student loan policy can evolve out of existing programs (including the federally sponsored secondary market which has been passed by both the House and Senate), and that radical departures such as a national student loan bank or collections through the Internal Revenue Service, while potentially valuable, are not essential to a sound national loan policy. Finally, we feel that any recommendation for a specific national loan plan would inevitably overestimate the importance not simply of that one plan, but of the role of loans in general, relative to all other public policy issues surrounding the financing of higher education.

A more productive approach toward a long range national policy on student loans, we believe, is to assume that any policy of federal support to higher education will need to be supplemented by an ever-increasing use of loans along with expanded grants and other forms of assistance. The need for more credit and for more manageable loan instruments can be met in a variety of ways following the general recommendations summarized in this report. Kept in such a perspective, we believe that the income contingent concept can contribute toward greater educational opportunity and a more secure financial future for our colleges and universities.

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